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NO. 83-

IN THE

Supreme Court Of The United States

October Term 1983

MERRILL N. BRADLEY and JULIA H. BRADLEY,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

JOHN R. MURRAY and EARLE B. MURRAY,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

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QUESTIONS PRESENTED

1. Does the form of a transaction using traditional real property conveyancing documents control over the substance of the same transaction?

2. Can the taxpayer, as distinguished from the United States, raise the issue as to whether or not the substance of a transaction does control over the form of that transaction?

3. Where the substance of a transaction purportedly conveying an interest in real property shows that the putative purchaser has no obligation to pay and can "walk away" from the transaction, and where the purchase price of the property is substantially in excess of the fair market value, has a sale for tax purposes occurred?

4. Where the purchaser of real property has no obligation to pay the purchase price and can "walk away" from the transaction, and where the purchase price substantially exceeds the fair market value, does the transaction have economic substance for tax purposes so as to create a genuine indebtedness causing payment of amounts designated as interest to constitute taxable interest income to the sellers?

5. Does the mere possibility that a debt may arise constitute a genuine indebtedness for income tax purposes upon which interest income can be founded?

6. Where periodic payments are made for the right to acquire property at a price substantially in excess of its value, but the prospective purchaser is neither obligated to make such payments nor purchase the property, is the underlying transaction, in substance, a true sale for income tax purposes or only the equivalent of an option arrangement?

7. Where periodic payments for the right to acquire an interest in real property are made, and the right to acquire such interest is neither exercised, nor abandoned, in the

relevant taxable year, do such payments, in substance, constitute taxable income in the year received?

The grant of this petition is sought on each of the grounds: (a) that in failing to hold that the substance of the transaction and documents involved should prevail over their form the Court of Appeals has decided a federal question in a way in conflict with decisions of this Court; and (b) that, in so doing, the Court of Appeals has arrived at a result that, in substance and effect, is in conflict with a decision of the Court of Appeals for the Ninth Circuit on essentially the same matter.

CERTIFICATE OF INTERESTED PARTIES

The undersigned counsel of record certifies that the following listed persons have an interest in the outcome of this case. These representations are made in order that the Judges of this Court may evaluate possible disqualification or recusal:

John R. Murray and Earle B. Murray,
Merrill N. Bradley and Julia H. Bradley,
Petitioners

United States of America, Respondent.

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OPINIONS BELOW

The opinion of the Court of Appeals is officially reported at 730 F.2d 718 (Adv. Sheets).

The date of the judgment sought to be reviewed and the time of its entry was April 23, 1984. The statutory provision believed to confer on this court jurisdiction to review

the judgment in question by writ of certiorari is Title 28 § 1254 (1) U.S. Code (62 Stat. 928). The jurisdiction of the District Court is conferred by Section 1346 (a) (1) of Title 28 U.S. Code.

STATUTES INVOLVED

The federal statutes involved in this case are parts of Title 26 United States Code incorporating the United States Internal Revenue Code of 1954 (the "1954 Code"), namely Sections 61 (68A Stat. 17), 163 (68A Stat. 46), 1001 (a), 1011 (a) and 1012, all as they existed in 1974-1976. In pertinent part, these sections read as follows:

"Sec. 61. GROSS INCOME DEFINED.

"(a) *General Definition.* — Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

. . . .

"(3) Gains derived from dealings in property;
"(4) Interest;

. . . .

"(13) Distributive share of partnership gross income;

. . . ."

"Sec. 163. INTEREST.

"(a) *General Rule.* — There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

. . . ."

"Sec. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

"(a) *Computation of Gain or Loss* — The gain from the sale or other disposition of property shall be the ex-

cess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized."

"SEC. 1011. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

"(a) *General Rule.* — The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses), adjusted as provided in section 1016."

"SEC. 1012. BASIS OF PROPERTY — COST.

"The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer."

STATEMENT OF THE CASE

By this petition, the petitioners seek to have this Court review the decision of the Court of Appeals for the Eleventh Circuit in a consolidated case in which the petitioners were the appellants, numbered 83-7143 in the Court of Appeals. The opinion of the Court of Appeals is copied in the Appendix.[1] This case involves claims for the refund of alleged overpayments of federal income taxes. On April 9, 1982, Merrill N. Bradley and Julia H. Bradley filed, in the District Court for the Northern District of Alabama, a complaint seeking the refund of overpayments of their 1974, 1975 and 1976 taxes (II-R 1-13).[2] On the same day, John R. Murray and Earle B. Murray filed in said District Court a complaint seeking the refund of an alleged overpayment of their 1974 taxes. (II-R. 1-11.) Both record references exclude exhibits. Both complaints raised the same issue — whether payments received by Merrill N. Bradley and Earle B. Murray at the execution of, and on a non-recourse promissory note they received pursuant to, a contract for the possible sale of real property constituted interest income.

Relevant parts of the complaint in John R. Murray and Earle B. Murray, Plaintiffs, v. U.S., Defendant, are contained in paragraphs 9 through 12. The complaint in the case of Merrill N. Bradley and Julia H. Bradley contains essentially the same averments except as to years involved, and other matters not material to this petition. They, with exhibits, are found at Volume II, pages 1-54, for the Murrays and Volume I, pages 1-42 for the Bradleys. The relevant facts alleged in the complaints are set forth in appro-

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[1]Page references followed by "a" are to pages in the appendix.

[2]"I-R." "II-R." and "III-R" references are to the three volumes of the original record on appeal as repaginated by the Clerk of the District Court and transmitted to the Court of Appeals.

priate parts of this Statement of the Case. So are the relevant parts of the controlling documents.

The numbers assigned in the following summary correspond generally with the numbers in the complaint but those paragraphs are not always copied verbatim.

9. Important provisions of the relevant documents make clear the contingent character of the commitments of Thompson Properties. On September 18, 1974, Thompson Properties executed a note styled "Alabama Mortgage Note" in which the due dates and the payments, designated as interest and principal, respectively, are shown as:

Due Date	Interest	Principal	Total Annual Payment
Closing	51,200	-0-	51,200
September 18, 1975	51,200	-0-	51,200
September 18, 1976	51,200	-0-	51,200
September 18, 1977	51,200	-0-	51,200
September 18, 1978	51,200	-0-	51,200
September 18, 1979	51,200	-0-	51,200
September 18, 1980	51,200	-0-	51,200
September 18, 1981	-0-	128,000	128,000
September 18, 1982	40,960	128,000	168,960
September 18, 1983	30,720	128,000	158,720
September 18, 1984	20,480	128,000	148,480
September 18, 1985	10,240	128,000	138,240
	460,800	640,000	1,110,800

A true copy of the Alabama Mortgage Note was made Exhibit "E-8" to the complaint.

10. The first amount so designated as "interest" in the Alabama Mortgage Note was paid concurrently with the closing on September 18, 1974. The note contained the following sentence:

> "This note is subject to an exculpatory clause set forth in the mortgage executed and delivered on even date herewith."

In addition to the said exculpatory clause, the Alabama Mortgage Note included the following:

> "After maturity all principal and interest shall bear interest at the rate of 8% per annum until paid. If default shall be made in the payment of interest or principal when the same shall become due, or in the performance of any of the covenants or agreements contained in that certain real estate mortgage given to secure the payment hereof, the entire unpaid principal of this note with interest thereon, shall become due at once at the option of the holder of this note and to the extent permitted under the exculpatory clause set forth in the said mortgage this note may be sued upon and the indebtedness evidenced hereby may be collected in like manner as if the full time provided for this note had expired. With regard to the property subject to the lien of said mortgage securing this note, the parties to this instrument, whether maker, endorser, surety or guarantor, each for himself, hereby severally agree to have paid from the proceeds of foreclosure of the said property all costs of collecting, or attempting to collect, this note, and in the event it should become necessary to employ counsel to collect this obligation or to protect the lien of the security, to have so paid a reasonable attorney's fee, whether suit is brought or not. Each maker, endorser, surety and guarantor of this note severally agrees to all the provisions of this note and waives demand, presentment, protest, notice of protest, suit and all other requirements necessary to collect the indebtedness."

11. The mortgage referred to in the Alabama Mortgage Note was executed on a printed form designated as "Mortgage Form 97-1 Rev. Sept. 1957" printed by Roberts & Sons of Birmingham, Alabama, and included additional mate-

rial. A true copy of this mortgage was made Exhibit E-8 to the complaint. The exculpatory clause therein, referred to in the Alabama Mortgage Note, reads as follows:

> "Exculpatory Clause: Notwithstanding anything to the contrary contained in this mortgage instrument or in the Promissory Note secured hereby, it is understood and agreed that this mortgage and said promissory note are executed *on the condition*, and the Mortgagee-Holder of said note covenants and agrees for themselves, their heirs, personal representatives and assigns, by their acceptance of delivery of this mortgage, that *the mortgagor, its partners, successors and assigns, shall not be individually or personally liable for any obligation under this mortgage or said promissory note secured hereby. The Mortgagee-Holder agrees not to institute suit upon said note*, but to proceed to foreclose this mortgage as herein provided, and, in the event that as a result of such foreclosure of this mortgage a lesser sum is realized than the amount then due and owing on said note, *the Mortgagee-Holder will not institute any action, suit or proceeding against the Mortgagor, its partners, successors and assigns, individually or personally, for and on account of such discrepancy or deficiency.*" [The italicizing has been added for emphasis.]

12. The mortgage also contained a release clause which reads as follows:

> "*Release Clause:* Mortgagee agrees to, and shall, release from the lien of this mortgage *parts* of the property described herein, by execution, acknowledgment and delivery of *appropriate deeds of partial release* (based, where necessary, upon a survey of the property released prepared by a surveyor hired by mortgagor at mortgagor's expense), which *releases* shall be upon the following terms and conditions:
>
> "1. The property subject to the lien of this mortgage shall be released from such lien at a price computed at

> $3,000 *of principal* per acre. Subject to the conditions below, *mortgagee shall have the right to choose which which acres are released.*
>
> "*The first parcel* to be released shall have access to a paved road and shall not be less than twenty (20) acres. *Each additional parcel to be released* shall be contiguous with a part of the parcel previously released and shall be not less than twenty (20) acres and mortgagee agrees that the *parcels to be released* from the lien of this mortgage will have a percentage or road frontage not less than that percentage which the property released bears to the total acreage not released.
>
> "2. Mortgagee agrees to grant releases for easements across the property to appropriate utility companies for public water supply, telephone, natural gas and electric power, and for roads. *The granting of such releases shall be subject to the location of the easements satisfactory to mortgagee*, but mortgagee's consent shall not unreasonably be withheld. No charge shall be made by mortgagee for the granting of such easements." [The italicizing is added for emphasis.]

The cases were consolidated on October 5, 1982. (I-R. 47-51.) A trial was held before Judge Sam C. Pointer, Jr. without a jury on November 17, 1982. (I-R. 52.) At the end of the trial, Judge Pointer rendered judgment for the respondent. A transcript of the trial proceedings is found in the Record at Volume III, pages 1-113, and the Court's findings and conclusions are at pages 114-123 of that same volume.

Petitioners Merrill N. Bradley ("Dr. Bradley") and Earle B. Murray ("Mrs. Murray"), brother and sister, each owned an undivided half interest in approximately 320 acres of land near Lovick, Alabama (the "Lovick Land"). Their spouses, respectively, Julia H. Bradley and John R. Murray, are also petitioners herein as both couples filed

joint income tax returns. On or about July 27, 1974, one Gary L. Thompson ("Mr. Thompson") approached petitioner John R. Murray and sought to acquire an interest in the Lovick Land. On July 30, 1974, a document, styled a real estate sales contract, was entered into with Dr. Bradley and Mrs. Murray as sellers and Mr. Thompson, or his assigns, as purchaser. The purchase price was stated as $2,000 per acre (R. Vol. II, p. 35).

The purchaser, Thompson, was in the real estate investment business (R. Vol. III, p. 10). An Alabama limited partnership named "Thompson Properties 118 AA 320, Ltd." ("Thompson Properties") was set up and ultimately acquired the interest in the Lovick Land as assignee of Mr. Thompson under the contract for sale (R. Vol. III, p. 29). This was the eighteenth limited partnership set up by Mr. Thompson since 1973 (R. Vol. III, p. 29). The transaction was so arranged by Thompson that there was no promise to pay any money other than the initial payment required by the sales contract, and that there was no personal liability on any of the partners of Thompson Properties to make any further payment (R. Vol. III, p. 31). Relevant provisions of the documents are copied on pages 5-8. Although it was anticipated by the purchaser that land values would increase approximately twenty percent (20%) per year, thus potentially generating a profitable transaction, another reason for the transaction was the anticipated tax benefits from having what the limited partners believed to be valid interest deductions, with limited personal liability (R. Vol. III, pp. 38-41).

After the original sales contract was accepted, some further negotiations were entered into which culminated in the execution of certain real property instruments on September 17 and 18, 1974. The petitioners executed a deed of the Lovick Land to Thompson Properties reserving a vendor's

lien thereon to secure the unpaid purchase price and referencing a separate Purchase Money Mortgage (R. Vol. II, pp. 104A-104B).[3]

At the trial, there was proof of the execution and contents of the relevant documents as shown on pages 5-8. (R. Vol. II, pp. 106-11). Also on September 18, 1974, Thompson Properties executed in favor of the sellers, a general warranty deed reconveying the Lovick Land back to the sellers. This deed was delivered to the attorney for Thompson Properties as escrow agent with instructions that it be delivered to sellers upon written notice of default by Thompson Properties under the Purchase Money Mortgage. (R. Vol. II, pp. 113-116). The original deed from the sellers and the mortgage deed from Thompson Properties were recorded on September 20, 1974.

Although the sale price for the subject land was stated in the documents as $2000 per acre, and the documents further provided for payment of $3000 per acre for releases of parcels of the property, these sums were substantially in excess of the fair market value of the property (R. Vol. III, p. 117). The petitioners introduced testimony of a qualified real estate appraiser to the effect that the true market value of the property was only $750 per acre on the average. (R. Vol. III, p. 62).

On September 17, 1974, Mr. Murray transmitted a title binder to purchaser's attorney with an accompanying letter. The letter dealt with various aspects of the transaction including the concern regarding whether mortgage recording fees would have to be paid when there is "no promise to

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[3]These pages, although appearing in the Record, were for some reason not numbered. They appear in Volume II immediately following page 104 and for purposes of clarity your petitioners have designated these pages as 104A and 104B.

pay." The letter also clearly characterized the interest granted by sellers as an option (R. Vol. II, pp. 116A-116B).[4]

All of the Lovick Land was covered by the lien of the mortgage. No property was released therefrom until July 31, 1978. At that time an agreement was entered into by the parties for the release of 54.8 acres of the land. Thompson Properties had a contract to sell this 54.8 acres to a third party and they had to obtain the approval and release of the sellers in order to sell that property (R. Vol. III, p. 16). The remaining land was then identified into five (5) additional parcels for future release. No further property was ever released. Thompson Properties attempted to sell additional parcels of the land to third parties, but after percolation tests showed the property unsuitable for development the sales efforts were abandoned (R. Vol. III, pp. 21-24). In 1979, the purchaser defaulted on the terms of the mortgage and note, and the record title came back to the sellers on or about October 8, 1979 (R. Vol. III, p. 101). The statements in this paragraph are probably not material, but the evidence was introduced to show the entire history.

Each of the petitioner sellers ultimately paid federal income tax on the payments received from Thompson Properties designated as interest. None of that has been refunded. Subsidiary findings by the District Court on which the petitioners rely are stated on page 13.

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[4]These pages, although appearing in the Record, were for some reason not numbered. They appear in Volume II immediately following page 116 and for purposes of clarity your petitioners have designated these pages as 116A and 116B.

ARGUMENT

I. The Principle That The Substance Of A Document Or Transaction Should Control Over Its Form Is Available To The Taxpayer As Well As To The Government.

In its opinion, the Court of Appeals deals expressly with only one issue which the petitioners undertook to present to that Court. This issue, and its answer, are stated by the Court in the following sentence:

> "Taxpayers argue that this Court must pierce the form of the agreement that taxpayers voluntarily entered into. Binding legal precedent forecloses such an argument. *See Id.* Taxpayers have failed to follow this Court's ruling in *Spector.*" [i.e., *Spector v. Commissioner*, 641 F.2d 376, 381 (5th Cir., Unit A 1981] App. p. 5a.

The Court then calls attention to its adoption, as binding precedent, of all of the decisions of the Fifth Circuit handed down prior to October 1, 1981. We shall cite such cases with the same intended effect.

This issue is most often stated in terms of the principle that, in income tax cases, substance should prevail over form. In its dealing with that issue and in its failure to cite the principal authority on which the petitioners relied but which the Court of Appeals does not mention, that Court appears to be assuming that a decision against these petitioners would, more or less inescapably, be favorable to the Government.

However, that is not necessarily a valid assumption and, as will appear from the petitioners' relevant authority, it may well be that, on balance, the decision is unfavorable to the Government. However, the record does not show enough facts for that question to be determined. That it presents an issue results from the fact that, if the amounts

paid to the sellers of the Lovick Land designated as "interest" are, in accordance with the arguments of petitioners, held to be equivalent of payments to extend what was essentially an option, then an interest deduction, otherwise available to them under Section 163 of the 1954 Code, would be disallowed to the partners in Thompson Properties. While consistency can be required in the case of the taxpayer, this Court has also held that the government is foreclosed from successfully maintaining inconsistent positions. *Bull v. U.S.*, 295 U.S. 247, 256 (1935).

In support of the contention about denial of an interest deduction to the partners of Thompson Properties, the petitioners rely, primarily, on the decision of the Court of Appeals for the Ninth Circuit in *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (1976). The basic inconsistency between this decision and the decision of the Court of Appeals of the Eleventh Circuit in the case at bar is the occasion for the presentation of the contention that there is an essential conflict between the two decisions on essentially the same matter which only this Court can, and, as petitioners contend, should, consider as a predicate for granting the petition.

That contention is predicated upon the significance of the fact found by the District Court that the stated purchase price for the property was substantially in excess of its true market value at the time of the transaction (R. Vol. III, p. 117), and proof that there was no personal obligation on the part of the purchaser (Thompson Properties) to make any payments, and that the purchaser could just "walk away" from the transaction (Vol. III, pp. 115, 119), and that the petitioners' only remedy in the case of default by the purchaser was the forfeiture of the purchaser's rights in the Lovick Land (R. Vol. III, p. 115).

It is important to bear in mind that, if the petitioners

should prevail in this cause, they would not escape taxation of income for, on the exercise, or abandonment, of what they urge was essentially an option, gain might be realized, dependent upon the basis of the property. Evidence was introduced about both the Thompson Properties' exercise of an option to buy part of the Lovick Land, and its subsequent abandonment of the transaction, each of which involved the realization of taxable gain by the sellers. These events occurred after the taxable years involved in this case, but they were gone into to supply complete information, see page 11.

As stated on page 10, the evidence that led to the finding by the District Court that the nominal sale price of the Lovick Land exceeded its fair market value at the time of the transaction included the testimony of a qualified real estate appraiser that the average value at that time did not exceed $750.00 per acre, as compared with the average sale price of $2,000 per acre (R. Vol. II, p. 62). After the receipt of this testimony, the District Court declined to hear any more evidence on the subject, and then found that the nominal selling price was "substantially" in excess of the fair market value (R. Vol. II, p. 117). This finding has not been challenged.

In dealing with the substance-over-form question, the Court of Appeals cited *Commissioner of Internal Revenue v. National Alfalfa Dehydrating & Milling Corp.*, 417 U.S. 134 (1974), and dealt with *Frank Lyon Co. v. U.S.*, 345 U.S. 561 (1978) on which petitioners had relied. According to the petitioners' view of *National Alfalfa*, the decision therein does not shed any significant light on the relatively narrow issue presented in this case. The petitioners recognize that *Frank Lyon* is not a decision, but only a dictum in their favor, but a powerful one.

However, in that case this Court did recognize the avail-

ability of the substance-over-form principle to the taxpayer, though it was not necessary to that decision. However, the Court of Appeals apparently overlooked the facts that, in *Frank Lyon*, not only did this Court recognize the availability of the principle to the taxpayer, but that it also included a quotation from perhaps the latest of the leading cases in which the taxpayer prevailed upon the application of that principle, and otherwise approved it.

In its opinion therein, this Court quoted from the opinion of Justice Black in *Helvering v. F & R Lazarus Co.*, 308 U.S. 252, 255 (1939), as follows:

> "In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding."

While *Lazarus* is not a notably recent case, the fact that its applicability was recognized in *Frank Lyon* and given emphasis by quotation from the opinion therein, makes it clear that this Court continues to recognize that the taxpayer can invoke the principle that substance should prevail over form. Indeed, the Court expressly approved the result in *F & R Lazarus* by saying that it had "rightly concluded" that depreciation was deductible by the taxpayer despite the "nomenclature" of two documents. That principle has been applied in several cases, going back to the inception of the law in dealing with the Sixteenth Amendment. In addition to those cited, the cases include: *Helvering v. Tex-Penn Oil Company*, 300 U.S. 481, 492-3 (1937); *Eisner v. Macomber*, 252 U.S. 189 (1920); and the earliest, *Towne v. Eisner*, 245 U.S. 418 (1918). The last named case held that if the statute there involved were construed so as to tax a stock dividend, it would be unconstitutional, since such a dividend was not income but capital.

Another decision favorable to the taxpayer which holds that the principle that substance prevails over form is available to the taxpayer is that in *Bartels v. Birmingham, Collector*, 332 U.S. 125 (1947). This involved the liability of the employer for social security taxes. It is perhaps worthy of note as to the diligence of the Court of Appeals in examining this question to observe that *Commissioner v. Danielson*, 378 F.2d 771 (3rd Ct., 1967), followed by *Spector*, was a decision of the full court from which there were three dissents. The dissenting opinion cites some cases which the Government won, but also four decisions of this Court which were favorable to the taxpayer on the substance-over-form issue, namely, *Eisner v. Macomber, F & R Lazarus, Tex-Penn Oil* and *Bartels*, (378 F.2d 781). Neither the Fifth Circuit in *Spector* nor the Eleventh Circuit in this case, mentioned any of those cases even though in *Spector*, the Fifth Circuit adopted the *Danielson* rule, stated and discussed later.

Several cases in which the courts have given effect to the terms of an agreement between the parties to affect the amount of taxable income or of a deduction available to the parties to a contract involve non-compete agreements. These cases follow an agreement negotiated by the parties as the basis for determining how much income is received by a seller and how much of a deduction is allowable to the purchaser. This line of cases includes *Barran v. Commissioner*, 334 F.2d 58 (5th Ct., 1964) which is cited in the opinion of the Court of Appeals (App. 5a). However, those cases involve substantially different legal principles, as well as facts, from the case at bar, so they are not considered further on this point.

The taxpayers in *Barran* were, in one aspect, unable to avoid taxation based on the holding in such cases. But, in another, they prevailed on the basis of a holding that makes

it clear that the Court of Appeals would not follow even one of its own decisions, let alone decisions of this Court, to apply the substance-over-form principle in favor of the petitioners. The partnership there involved sold substantially all of its assets. In holding that this effected a sale of the partnership interest of one of the taxpayers, the Court said, "Under these circumstances, we find that *in substance* the transaction was a sale of partnership interests, and the Tax Court erred as a matter of law in not so construing it." (334 F.2d at 65, emphasis added)

This, then, is an express decision of the Fifth Circuit applying the substance-over-form principle in the taxpayer's favor. How could that Court have failed to do it in the case at bar? The citation appears in the middle of discussions of *Spector*, to supply part of the support for a statement that, in *Spector*, the Fifth Circuit had allowed a taxpayer to challenge the form of a transaction "where it is necessary to avoid unjust results." But why in *Barran* and not in the case at bar, especially when the Government might have procured more taxes by pursuing the Thompson Properties partners? Again, why was it not an "unjust result" that the petitioners were not given the benefit of a holding favorable to them if, in fact, they were entitled to it on the application of that principle?

Three of the cases that applied the substance-over-form principle in favor of the taxpayer are discussed in the prevailing opinion in *Danielson*, namely, *F & R Lazarus*, *Bartels* and *Tex-Penn Oil*. Each is distinguished on a ground that petitioners submit is inadequate. (378 F.2d at 778) The significance of this here is that, while, in *Spector*, the Court of Appeals adopts the *Danielson* rule, it takes no cognizance of the holdings in these three cases, one of which is cited with approval in *Frank Lyon Co.*

Since a chief reliance is on *Spector*, it should be observed

that, in none of the decisions of this Court applying the principle in favor of the taxpayer which are cited by petitioners is there any explicit requirement that the taxpayer can "challenge the tax consequences of his agreement as *construed by the Commissioner* only by adducing proof which in an action between the parties would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." the *Danielson* rule (378 F.2d at 771 copied on 641 F.2d 283, emphasis added)

The applicable cases in this Court appear to require no more evidence from the taxpayer than is required to carry the burden of proof, generally a mere preponderance. Certainly, this Court implicitly held in *Tex-Penn Oil Co.* that the Commissioner's construction of the documents was not controlling, thus overriding *Danielson* and *Spector.*

The failure of the Court of Appeals to follow decisions of, and expressions of opinion by, this Court in at least six cases, is all the more remarkable when it fails to follow its own decision in *Barran*, though cited in the opinion. This disregard of controlling decisions surely justifies grant of this petition.

Obviously, the *Danielson* rule is contrary to the principles that tax laws are to be liberally construed in favor of the taxpayer and that the facts, as well as the law, shall not be viewed unfavorably to him. *Cf. Burnet v. Niagara Falls Brewing Co.*, 282 U.S. 648, 654-5 (1931).

In analyzing the facts, two terms must be defined. The first term, "interest", is not defined in either Section 61, dealing with it as one item of gross income, or in Section 163 of the 1954 Code, dealing with it as a deduction.

In *Deputy v. DuPont*, 308 U.S. 488, 498 (1940) involving an effort to deduct interest, this Court said:

> "In the business world 'interest on indebtedness' means compensation for the use or forbearance of money. In the absence of clear evidence to the contrary, we assume that Congress has used these words in that sense."

This definition was approved, and parts of it copied, in the opinion in *United States v. Midland Ross Corp.*, 381 U.S. 54 at 57 (1965), another income tax case.

While the Government prevailed in these two cases, it did not in *Old Colony Trust Company v. Commissioner*, 284 U.S. 552, 560 (1932). This case was relied on in *Deputy v. DuPont* for the statement that "as respects 'interest' the usual import of the term is the amount one has contracted to pay for the use of borrowed money." Some obligation to pay appears to be required to generate taxable income or deductible interest. Here, there was no such obligation.

The second term to be defined is indebtedness, for it is only interest on "indebtedness" that is allowed as a deduction by Section 163 of the 1954 Code. As used in the revenue acts, it implies an "unconditional obligation to pay", *Gilman v. Commissioner*, 53 F.2d 46, 50 (6th Cir., 1931). In *Autenreich v. Commissioner*, 115 F.2d 856 (3rd Cir., 1940), this is expanded to say that it means "an unconditional and legally enforceable obligation for the payment of money."

These concepts are relied on, and other cases of like import are cited, in *Estate of Franklin*, 544 F.2d at 1049. This case presents a set of facts which is the converse of those involved in the case at bar. We rely on it to induce the Court to realize that the partners of Thompson Properties could not deduct, as interest, payments made by it which were designated as such, and to establish the existence of the conflict noted above, page 13.

II. There Is A Conflict Between The Decision In The Case At Bar And A Decision Of The Ninth Circuit In *Estate Of Franklin v. Commissioner*, Which This Court Should Consider And Decide That The Decision Of The Court Of Appeals Should Be Reversed.

The District Court found, or stated, that Thompson Properties had no personal obligation to make any payment (Vol. III, p. 115), that it could just "walk away" from the transaction at any time (Vol. III, p. 117), and that the purchase price of the Lovick Land was *substantially* in excess of its fair market value (Vol. III, p. 117). Findings like these and others shown on page 13 were precisely what caused the Ninth Circuit to hold, in *Estate of Franklin*, that a similar transaction lacked sufficient economic substance for income tax purposes. Thus, this holding, if applied to the situation at bar, would result in the denial of an interest deduction to the partners of Thompson Properties.

In *Estate of Franklin*, the taxpayer was a member of a limited partnership which entered into a transaction to purchase a motel. A sales agreement, which was recorded, provided that the partnership would make one prepaid interest payment, then monthly principal and interest payments for ten years, and thereafter a final balloon payment. The purchase obligation of the limited partnership was non-recourse, and, in the event of default, the seller's only remedy was forfeiture of the partnership's interest. The sale was combined with a leaseback. Interest deductions by the taxpayer were disallowed by the Tax Court, and this determination was affirmed by the Ninth Circuit, although for different reasons. The most pertinent part of the Ninth Circuit opinion reads:

> "it has been long recognized that the absence of personal liability for the purchase money debt secured by

> a mortgage on the acquired property does not deprive the debt of its character as a bona fide debt obligation able to support an interest deduction . . . However, this is no longer true when it appears that the debt has economic significance only if the property substantially appreciates in value prior to the date at which a very large portion of the purchase price is to be discharged. Under these circumstances the purchaser has not secured 'the use or forbearance of money.' [citation omitted] *Nor has the seller advanced money or forborne its use.*" (544 F.2d at 1048-49, emphasis added)

It is at this point that the Court refers to other authorities about the nature of interest, as noted above. Obviously, if a purchasing taxpayer's interest deductions, based on such a transaction, are to be disallowed, then no interest income should be imputed to a selling taxpayer. See *Bull v. U.S.* Indeed, this was made explicit in the emphasized language above, "[n]or has the seller advanced money or forborne its use." *Estate of Franklin* at 1049.

This is precisely what occurred in the instant transaction. Thompson Properties was anticipating substantial yearly increases in the value of the Lovick Land. The price to be paid was substantially in excess of the fair market value, yet, as there was no personal liability for the obligation to pay this price, the purchaser could "walk away" at any time if the increase did not occur, or for any reason making the purchase less attractive. The term "walk away" was first used in the Tax Court opinion. It is repeated in the opinion of the Court of Appeals (544 F.2d 1247), and Judge Pointer used it in his findings (R. Vol. III, p. 117).

Franklin has been consistently followed by the Ninth Circuit, and expressly adopted by the Tax Court. See *e.g., Brannen v. Commissioner,* 78 T.C. 471 (1982). The petitioners submit that these cases establish a conflict sufficient to induce the Court to grant this petition. Petitioners also

submit that the Court should recognize the soundness of the reasoning in these cases, and ultimately reverse the judgment of the Court of Appeals.

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APPENDIX

BRADLEY v. UNITED STATES

Merrill N. BRADLEY, et al. and John R. Murray, et al.,
Plaintiffs-Appellants,

v.

UNITED STATES of America,
Defendant-Appellee.

No. 83-7143.

United States Court of Appeals,
Eleventh Circuit.

April 23, 1984.

Taxpayers filed suit for refund, claiming that funds received from real property purchaser were payments on continuing option and not interest income. From adverse judgment of the United States District Court for the Northern District of Alabama, Sam C. Pointer, Jr., Chief Judge, taxpayers appealed. The Court of Appeals, Hatchett, Circuit Judge, held that absent any evidence to prove existence of mistake, undue influence, fraud, or duress so as to merit release from sales transaction form that taxpayers voluntarily employed, they could not alter that form for tax purposes and, hence, funds received were properly treatable as interest income subject to tax assessment.

Affirmed.

1. Internal Revenue Key No. 3071

Commissioner of Internal Revenue may, in determining income tax liabilities, look through form of transaction to its substance.

2. Internal Revenue Key No. 3071

Commissioner of Internal Revenue may, in determining income tax liabilities, bind taxpayer to form in which taxpayer has cast a transaction.

3. Internal Revenue Key No. 3071, 3132

Taxpayers who sought refund, contending that funds received from real property purchaser were payments on continuing option and not interest income, failed to produce type of evidence necessary to alter form in which they cast their sales agreement, namely, such evidence as might prove existence of mistake, undue influence, fraud, or duress so as to merit release from the transaction form that they voluntarily employed; hence, form could not be altered for tax purposes and funds received were properly treatable as interest income. 26 U.S.C.A. § 61 (a) (4).

Appeals from the United States District Court for the Northern District of Alabama.

Before KRAVITCH, JOHNSON and HATCHETT, Circuit Judges.

HATCHETT, Circuit Judge:

In this tax case, we review the district court's ruling that the transaction between appellant taxpayers and an Alabama limited partnership constituted a sale of property, rather than an option to purchase, and that the payments derived therefrom were interest income subject to tax assessment under 26 U.S.C.A. § 61 (a) (4) (West 1967). We affirm.

Facts

The appellant taxpayers were co-owners of approximately 320 acres of land (hereinafter Lovick property) near

Lovick, Alabama. On July 27, 1974, Gary L. Thompson (Thompson) asked appellant, John Murray, to sell him the Lovick property.

On July 30, 1974, the taxpayers, as sellers, and Thompson, as purchaser, negotiated and entered into a real estate contract. Thompson organized an Alabama limited partnership named "Thompson Properties 118AA 320 Ltd." (Thompson Properties) which ultimately took the interest in the land under the contract for sale.

The contract called for an initial payment of interest, five subsequent annual interest payments, then six annual payments combining interest and principal. To secure the debt on the property, Thompson executed a mortgage deed. The mortgage deed covered the land for the full purchase price and contained an exculpatory clause absolving the purchasers of any personal liability thereon and limiting taxpayers' remedy solely to foreclosure on the property. Thus, the purchase price was evidenced by a nonrecourse note from Thompson Properties.

As consideration for the promissory note and mortgage, taxpayers gave Thompson Properties the deed to the property. Thompson Properties, for the next four years, paid the annual interest and property taxes. In addition, Thompson Properties rented a house on the premises.

In 1979, Thompson Properties defaulted on the mortgage and note, the taxpayers took delivery of the deed under an escrow agreement, and record title was returned to taxpayers.

The taxpayers, in their 1974, 1975, and 1976 income tax returns, included amounts received under the agreement as interest income. In September, 1977, through amended returns for 1974, 1975, and 1976, the taxpayers claimed refunds contending that the funds received under the agreement were payments on a continuing option and not in-

terest income. After a second filing of amended returns, the taxpayers' refund claims were denied. The taxpayers then filed this suit for a refund in the district court alleging overpayments of their 1974, 1975, and 1976 taxes.

At trial, the district court ruled that the payments received by taxpayers on the promissory note were interest income pursuant to a "sale" and, therefore, were properly taxed during the years in question.

Taxpayers contend that the district court erred in finding that the payments received by taxpayers were interest income. In support of this contention, taxpayers assert that the transaction at issue lacked sufficient economic substance to give rise to tax liability because no genuine indebtedness existed on the part of the purchaser. Succinctly stated, taxpayers claim that the transaction, although appearing to be a "sale" of property, was actually an "option" agreement whereby the purchaser, Thompson Properties, made annual payments to keep open a right to purchase in the future.

Issue

The issue before this court is whether a taxpayer may challenge the tax consequences of his own agreement in the absence of proof which, in an action between the parties, would be admissible to alter the contract's construction or to show its unenforceability because of mistake, undue influence, fraud, duress, et cetera.

Discussion

[1,2] It is well settled law that the Commissioner of the Internal Revenue Service, in determining income tax liabilities, may look through the form of a transaction to its substance. The law further declares that as a general rule, the Commissioner may bind a taxpayer to the form in

which the taxpayer has cast a transaction. *Spector v. Commissioner*, 641 F.2d 376, 381 (5th Cir. Unit A 1981).[1]

[3] Correspondingly, the United States Supreme Court emphasized in *Commissioner of Internal Revenue v. National Alfalfa Dehydrating and Milling Corp.*, 417 U.S. 134, 94 S. Ct. 2129, 40 L. Ed. 2d 717, (1974), that: "This court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not." *National Alfalfa*, 417 U.S. at 147, 94 S. Ct. at 2136 (citations omitted).

In *Spector*, however, this circuit recognized an exception to the above-stated principle, and has, in some instances, allowed a taxpayer to challenge the form of a transaction when it is necessary to avoid unjust results. *Spector*, 641 F.2d at 382; *Barran v. Commissioner of Internal Revenue*, 334 F.2d 58, 63 (5th Cir. 1964). In *Spector*, the former Fifth Circuit observed:

> A party can challenge the tax consequences of his agreement as construed by the Commissioner *only by adducing proof* which in an action between the parties would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, et cetera.

Spector, 641 F.2d at 382 (quoting *Commissioner v. Danielson*, 378 F.2d 771, 775 (3rd Cir. 1967) (emphasis added.)

Taxpayers argue that this court must pierce the form of the agreement that taxpayers voluntarily entered into. Binding legal precedent forecloses such an argument. *See*

[1] In *Bonner v. City of Prichard*, 661 F. 2d 1206 (11th Cir. 1981) (en banc), this court adopted as binding precedent all of the decisions of the former Fifth Circuit handed down prior to the close of business on September 30, 1981. *Id.* at 1209.

Id. Taxpayers have failed to follow this court's ruling in *Spector.* Taxpayers have failed to submit any evidence to prove the existence of a mistake, undue influence, fraud, or duress so as to merit release from the transaction form that they employed.

Instead of following the court's ruling in *Spector,* taxpayers stray from binding precedent and now seek to support their position by citation to *Frank Lyon Co. v. United States,* 435 U.S. 561, 98 S. Ct. 1291, 55 L. Ed. 2d 550 (1978). The facts in *Frank Lyon* do not bear a notable resemblance to those in this case. After applying an "economic substance" analysis, the Commissioner, in *Frank Lyon,* attempted to pierce the form of a taxpayer's agreement in order to assess taxes on a business transaction. Subsequent to thorough examination of the transaction's substance, the Court held it to be in conformity with the form adopted by the taxpayer and, thus, rejected the Commissioner's challenge.

Frank Lyon is readily distinguishable from the present case. Unlike taxpayers in this case, the taxpayer in *Frank Lyon* did not seek to abandon its own agreement to obtain tax relief based upon the underlying economic substance of the transaction. The factual setting of *Frank Lyon* and this case are strikingly dissimilar and, therefore, inapposite. Accordingly, *Frank Lyon,* does not support taxpayers' argument and does not invalidate the former Fifth Circuit's ruling in *Spector.*

Because appellant taxpayers failed to produce the type evidence required by *Spector,* we conclude that they are unable to alter the form in which they cast their sale agreement. Thus, we affirm the district court's ruling that the tax was properly paid on the interest income.

AFFIRMED.